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96TH CONGRESS
2d Session

SENATE

REPORT
No. 96-1037

NET OPERATING LOSS CARRYOVERS OF REAL ESTATE INVESTMENT TRUSTS

COMPLETED

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 4968

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Ordered to be printed

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96TH CONGRESS, 2d Session } SENATE { REPORT No. 96-1037

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NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Order to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 4968]

The Committee on Finance, to which was referred the act (H.R. 4968) to amend the Internal Revenue Code of 1954 to provide that in certain cases the net operating loss carryover period for a taxpayer who ceases to be a real estate investment trust shall be the same as the net operating loss carryover period for a taxpayer who continues to be a real estate investment trust, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the act as amended do pass.

The amendment is shown in the text of the bill in italic.

House bill.—H.R. 4968, as it passed the House, provided certain former REITs an additional year of carryforward (with a maximum of eight years) of net operating losses for each year such former REITs are denied a NOL carryback because they had been REITs.

Committee bill.—The committee bill retains the House provision affecting REITs and adds provisions relating to (1) the rate of interest on U.S. retirement bonds (passed by the House as section 8 of H.R. 4746), (2) General Stock Ownership Corporations, and (3) the tax treatment of employees of charities working abroad (previously reported by the committee as section 201 of H.R. 1319).

I. SUMMARY

Section 1. Net Operating Loss Carryovers of Real Estate Investment Trusts

The bill permits trusts which are former real estate investment trust (REITS) an addition year to carry over operating losses for each year a carryback was not allowed because these entities were REITS in the carryback year. Under the bill, the maximum carryover period will be 8 years.

Section 2. Rate of Interest on United States Retirement Bonds

Under present law, the interest rate on an individual retirement bond issued by the Treasury Department or a retirement plan bond issued by the Treasury Department remains the same from the date of issuance until the bond is redeemed (generally when the owner retires, becomes disabled, or dies).

This section of the bill authorizes the Treasury Department to make upward adjustments in the interest rate on outstanding retirement bonds, so that such a bond would earn interest at a rate consistent with the yield for new issues of such bonds.

Section 3. Technical Amendments Relating to General Stock Ownership Corporations

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State). A corporation must meet certain statutory tests in order to be treated as a GSOC. Generally, a GSOC is exempt from Federal income taxation. The shareholders of the GSOC, however report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

This section makes several technical changes in the tax law relating to GSOCs.

Section 4. Tax Treatment of Employees of Charities Working Abroad

The Foreign Earned Income Act of 1978 generally replaced the prior $20,000 foreign earned income exclusion with a new system of itemized deductions for the excess costs of working overseas and an additional $5,000 deduction for employees working in hardship areas. As an exception to these new rules, the 1978 Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion in lieu of the new excess living cost and hardship area deductions.

The amendment allows individuals meeting the foreign residence or presence tests who perform "qualified charitable services" in less developed countries to elect, in lieu of the deduction for excess foreign living costs, an exclusion of $20,000 from gross income on the same basis as employees residing in camps in hardship areas. The amendment is effective for taxable years beginning after December 31, 1978.

II. EXPLANATION OF THE BILL

A. Net Operating Loss Carryovers of Real Estate Investment Trusts (sec. 1 of the bill and sec. 172 of the Code)

Present law

Prior to the Tax Reform Act of 1976, real estate investment trusts (REITs) were not allowed a net operating loss deduction. Because of the effect that this rule had during the economic downturn in the early 1970's, many trusts [1] terminated their status as REITs so that they could carry over net operating losses incurred by them during those years. In such a case, a former REIT was allowed to carry over its losses for five years. However, it was not allowed a deduction for the carryback of the net operating loss to years during which is qualified as a REIT.

The Tax Reform Act of 1976 made two changes that affected the net operating loss carryovers of corporations and REITs. First, it lengthened the time that corporations could carry over their net operating loss deductions from five years to seven years. This change was effective for losses incurred in years ending after December 31, 1975. Because of this effective date, losses incurred before 1976 by trusts which had terminated their REIT status were subject to the five-year carryforward of losses instead of the seven-year carryforward.

The Tax Reform Act of 1976 also changed the treatment of net operating losses of REITs. Under the 1976 Act, a net operating loss incurred in a year that the trust is a REIT can be carried forward for eight years. However, no net operating loss carrybacks are permitted. This change in rules was effective for taxable years of a REIT ending after October 4, 1976. As a result of this effective date, losses incurred before 1976 by REITs were subject to an eight-year carryforward if they retained their REIT status during the entire eight-year carryforward period. However, under the 1976 Act rule, a net operating loss incurred before 1976 could not be carried over to the 6th, 7th, or 8th carryforward year unless the trust was a REIT for all years from the loss year through the carryover year. Thus, a former REIT which incurred a net operating loss in a taxable year ending before October 4, 1976, is permitted less than an eight-year carryover.

Reasons for change

The committee believes that a trust that terminates its status as a REIT should not have fewer years to which it can carry a net operating loss than it would have had if the trust had retained its REIT status.

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[1] For this purpose, the term "trust" is used to describe the taxpayer even though corporations are permitted to be REITs under the Tax Reform Act of 1976.

Explanation of provision

This provision allows a trust which was formerly a REIT an additional year of carryforward (with a maximum of eight years) of net operating losses for each year that it is denied a net operating loss carryback because it was a REIT. This change allows a former REIT to have a total of eight carryover years. Thus, the treatment of these former REITs is similar to the treatment accorded to trust which retain their REIT status throughout the carryover period.

In addition, the provision removes the restriction that allows a net operating loss incurred before 1976 to be carried forward to the 6th, 7th, or 8th year only if the trust claiming the loss qualified as a REIT for all years from the loss year through the carryover year.

The provision also provides a special anti-abuse rule under which losses arising in taxable years ending before October 5, 1976, may not be carried forward if the principal purpose of the trust in losing its REIT status was to obtain the benefit of a net operating loss carryover.

Effective date

The provision is effective for taxable years ending after October 4, 1976.

Revenue effect

It is estimated that this bill will reduce budget receipts by a negligible amount in fiscal years 1981 and 1982, $7 million in 1983, $15 million in 1984, and $20 million in 1985.

B. Increases in Interest Rates Payable on United States Retirement Plan and Individual Retirement Bonds (sec. 2 of the bill and sec. 1 of the Second Liberty Bond Act (31 U.S.C. 752))

Present law

Under present law, a person eligible to establish an individual retirement account may purchase retirement bonds issued for this purpose by the Treasury Department. These bonds are not transferable and are subject to many of the restrictions that apply to individual retirement accounts. Retirement plan bonds are issued for H.R. 10 plans established by self-employed persons and for retirement and annuity plans established by employers for their employees. The interest rate on any such retirement bond remains unchanged throughout its life.

By contrast, the interest rates on issued Series E savings bonds are increased whenever there is an increase in the interest rates on new issues of Series E bonds. This adjustment is made in recognition of the holder's ability to redeem the outstanding bond before maturity and to reinvest the proceeds in new Series E bonds issued with the higher interest rate.

Reasons for change

Present law creates an inequity in the treatment of holders of different types of U.S. bonds. The owner of a Series E bond obtains the benefit of any higher interest rate designated for later-issued Series E bonds. The owner of a retirement bond receives the same interest rate throughout the bond's life, even if later-issued retirement bonds carry a higher rate.

In the absence of any provision authorizing adjustments in the interest rate for outstanding U.S. retirement bonds, potential purchasers may be expected to turn to various retirement plan arrangements offered in the private sector. Any net reduction in Treasury Department sales of retirement bonds will increase the amount of money that must be raised by the Treasury Department in some other manner.

Accordingly, the bill permits the Treasury Department to increase the interest rate paid on outstanding bonds.

Explanation of provision

This provision permits the investment yield (which term is used as identical to the interest rate) on U.S. retirement plan bonds (sec. 405 (b)) and U.S. individual retirement bonds (sec. 409(a)) to be increased for any interest accrual period so that the investment yield for that accrual period on the bonds is consistent with the investment yield for that accrual period on Series E savings bonds.

Any increased interest rates, and the accrual periods to which these rates apply, are to be specified in regulations to be issued by the Treasury Department. The provision provides that these regulations, to be effective, must be approved by the President.

Effective date

This provision applies to interest accrual periods that begin after September 30, 1977, with respect to bonds issued before, on, or after the date of enactment, but only for the purposes of increasing the investment yield on such bonds for interest accrual periods which begin after the date of enactment.

Revenue effect

It is estimated that this provision will have no effect on budget receipts, but it will increase outlays by $8 million in fiscal 1981 and by $2 million each year thereafter.

C. Technical Amendments Relating to General Stock Ownership Corporations (sec. 3 of the bill and secs. 1391–1397 of the Code)

Present law

Under present law, a State is authorized to establish a general stock ownership corporation (GSOC) for the benefit of all its citizens. It is anticipated that the GSOC will be permitted to borrow money to invest in business enterprises. The cash flow from the operation of the business would be used to service and repay the loan, and the remaining cash would be distributed to the GSOC shareholders (i.e., all the citizens of the State).

Present law provides that a corporation must meet certain statutory tests in order to be treated as a GSOC. The GSOC's corporate charter must provide for the issuance of only one class of stock, the issuance of shares only to eligible individuals, and the issuance of at least one share to each eligible individual if such eligible individual does not elect within one year after the date of issuance not to receive such share. Also, the charter must provide for certain restrictions on the tranferability of the GSOC shares. The transfer restriction must provide that the share cannot be transferred until the earliest to occur of (1) the expiration of five years from issuance, (2) death, or (3) failure to meet the State's residency requirements. In no event may shares of stock of a GSOC be transferred to nonresidents. Also, no person may acquire more than 10 shares of the GSOC's stock.

An eligible individual is any individual who is a resident of the chartering State as of the date specified in the enabling legislation and who remains a resident between that date and the date of issuance of the stock.

A GSOC must make an election to obtain special tax treatment. The effect of the election is to exempt the corporation from Federal income taxation. The shareholders of the GSOC would report their proportionate part of the GSOC's taxable income on their Federal individual income tax returns.

The GSOC computes its taxable income in the same manner as a regular corporation, with certain modifications. A GSOC is required to distribute 90 percent of its taxable income for any taxable year to its shareholders by January 31 of the next succeeding year. To the extent a GSOC fails to meet this distribution requirement, a tax equal to 20 percent of the deficiency (i.e., the difference between the required distribution and the actual distribution) is imposed on the GSOC.

Reasons for change

The committee believes it appropriate to clarify provisions in present law affecting GSOC's in order to make their utilization and management easier.

Explanation of provision

Under this provision, an estate can be a shareholder of stock in a GSOC. The amendment clarifies that the 20-percent tax on a deficiency (i.e., the difference between the required GSOC distribution and the actual GSOC distribution for the year) is deductible from the GSOC's taxable income for the year it is paid.

In addition, the bill makes several technical changes to the law governing GSOCs.

Effective date

The provisions apply with respect to corporations chartered after December 31, 1978, and before January 1, 1984.

Revenue effect

These provisions are not expected to have a direct effect on budget receipts.

D. Tax Treatment of Employees of Charities Working Abroad (sec. 4 of the bill and sec. 911 of the Code)

Present law

General

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. (The term "charitable" as used in this explanation includes educational, religious, scientific, literary, etc., purposes for which an exemption is allowed under Code section 501(c)(3).) In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. (The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.) However, because the provisions of the 1978 Act were effective on January 1, 1978, and the Act did not become law until November 8, 1978, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under prior law (the exclusion as amended by the Tax Reform Act of 1976) so that the 1978 Act would not have any mandatory retroactive effect. It was anticipated that this election would be of particular interest to employees of domestic charitable organizations, since under the 1976 Act they would continue to be eligible for a $20,000 exclusion, even though it would be subject to the new computation rules of the 1976 Act.

Excess living cost deduction

The new excess living cost deduction (new Code sec. 913) provided by the 1978 Act consists of separate elements for the general cost of living, housing, education, and home leave costs. Employees of charita-

ble organizations are allowed these deductions on the same basis as other individuals. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14 step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach fare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

Exclusion for employees in hardship area camps

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. Lodging is not a "camp" unless it is substandard lodging which is (i) provided by or on behalf of the employer for the convenience of the employer because the place at which the individual renders services is in a remote area where satisfactory housing is not available on the open market; (ii) located, as near as practicable, in the vicinity of the place at which the individual renders services; and (iii) furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees. The term "hardship area" has the same meaning for purposes of this provision as for the deduction for excess foreign living costs (sec. 913).

Reasons for change

Many charitable employees working abroad are eligible for a deduction for excess foreign living costs which is considerably less than $20,000 annually. Because these employees generally do not reside in camps, they may not elect the $20,000 annual exclusion. This change from prior law has resulted in a substantial increase in the tax liabilities of these individuals. For the most part, the committee believes that this increase is consistent with the intent of Congress in its refinement, through the Foreign Earned Income Act of 1978, of the tax relief afforded to Americans working abroad. However, the committee also believes that charitable employees in developing countries generally

are performing services which the United States has a special interest in supporting. Accordingly, these employees should be afforded an incentive along the lines of that provided for employees in hardship area camps under the 1978 Act.

Explanation of provision

The provision allows individuals meeting the foreign residence or presence tests in certain developing countries who perform "qualified charitable services" to elect, in lieu of the deduction for excess foreign living costs, an exclusion of $20,000 from gross income on the same basis as employees residing in camps in hardship areas. "Qualified charitable services" are defined to mean services performed by an employee for an employer which meets the requirements of Code section 501(c)(3). The developing countries for which the provision applies are those countries other than (i) the countries listed in the first sentence of section 502(d) of the Trade Act of 1974 or (ii) countries designated by the President as not being lesser developed countries.

Effective date

The provision applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce fiscal year receipts by $40 million in 1981, $18 million in 1982, $19 million in 1983, $21 million in 1984, and $22 million in 1985.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 4968, as amended. The committee estimates that the bill will reduce budget receipts by $40 million in fiscal year 1981, $18 million in fiscal year 1982, $26 million in fiscal year 1983, $36 million in fiscal year 1984, and $45 million in fiscal year 1985.

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority and no new tax expenditures, but will increase the existing tax expenditures by $40 million in fiscal year 1981, $18 million in 1982, $19 million in 1983, $21 million in 1984, and $22 million in 1985 (sec. 4 of the bill).

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 4968, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the regulatory impact that might be incurred in carrying out the provisions of this bill, H.R. 4968, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation.—The bill does not regulate any individuals or businesses, but amends certain provisions of the law. The bill increases the interest rate on certain U.S. bonds thus affording holders a more equitable return. The bill also alleviates the adverse impact of some tax provisions on certain investment entities and individuals, thus, improving their economic status.

Impact on personal privacy.—The provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The bill will not have any adverse impact on paperwork for persons affected by its provisions. The provision relating to the tax treatment of employees of charities working abroad will simplify tax reporting for such individuals and their employers.

V. CHANGES IN EXISTING LAW MADE BY THE BILL AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, H.R. 4968, as reported by the committee).

O